

Assessment of Commercial  
Revenues - Heathrow Airport (Stage  
3)

**Final Report**

Report

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## Disclaimer

Our work is produced for the Civil Aviation Authority for use in association with its consideration of Q6 price control arrangements for London Heathrow Airport and is not intended to be relied upon by third parties. Steer Davies Gleave accepts no liability for the use of this document other than for the purpose for which it was commissioned.

The projections contained within this document represent Steer Davies Gleave's best estimates. While they are not precise forecasts, they do represent, in our view, a reasonable expectation for the future, based on the most credible information available to us as of the date of this report. However, the estimates contained within this document rely on numerous assumptions and judgements and are influenced by external circumstances that can change quickly and influence income.

This analysis is based on data supplied by the client/collected by third parties. This has been checked whenever possible, however Steer Davies Gleave cannot guarantee the accuracy of such data and does not take responsibility for estimates in so far as they are based on such data.



# 1 Introduction

## Scope

- 1.1 Steer Davies Gleave was appointed by the Civil Aviation Authority (CAA) to support its assessment of commercial revenues at London Heathrow Airport as part of the price control arrangements for the forthcoming Quinquennium 6 (Q6) period (2014/15 - 2018/19 inclusive).
- 1.2 Previously we reviewed the commercial revenues projections in Heathrow Airport's Initial ("IBP") and Final ("FBP") Business Plans, along with a technical report provided by Nyras, acting as consultant to British Airways (their findings were also shared with the LACC). Our Final Report was published in April 2013.
- 1.3 Subsequent to this and the publication of the CAA's Initial Proposals for Q6 prices at Heathrow the following stakeholder responses provide substantive comments on our findings:
  - "Response to CAA Initial Proposals CAA/Q6/70" (Heathrow Airport).
  - "A response to the CAA's Initial Proposals by British Airways".
  - "Response of the Airline Community to the CAA Q6 Initial Proposals for the Regulation of Heathrow Airport" (LACC).
- 1.4 Heathrow Airport has also published a "Q6 Revised Business Plan" (based on an assumed capital investment programme of circa £2 billion) and a "Q6 Alternative Business Plan" which assumes a circa £3 billion investment programme.
- 1.5 We review these responses in this document, which provides an update to our April 2013 Final Report and should be read in conjunction with it. We also review the changes made to the Heathrow Airport commercial revenue forecasts shown in the Q6 Alternative Business Plan. Where relevant we have proposed adjustments to the projections presented in our Final Report.  
**April 2013 Steer Davies Gleave Projections**
- 1.6 The commercial revenue per passenger projections we set out in our April 2013 Final Report are illustrated below.

**TABLE 1.1 HEATHROW AIRPORT Q6 COMMERCIAL REVENUES PER PASSENGER (2011/12 PRICES)**

Category	Q5		Q6				
	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Retail	5.32	5.32	5.37	5.58	5.76	5.76	5.91
Car Parking	0.82	0.85	0.94	0.96	0.98	1.03	1.05
Property	1.43	1.38	1.45	1.48	1.46	1.45	1.43
<b>TOTAL</b>	<b>7.57</b>	<b>7.55</b>	<b>7.76</b>	<b>8.02</b>	<b>8.20</b>	<b>8.24</b>	<b>8.39</b>

*Source: Steer Davies Gleave April 2013 Final Report*

- 1.7 For its Initial Proposals the CAA used Steer Davies Gleave’s revenue per passenger projections for Q6 in conjunction with the CAA’s own forecasts of passenger traffic.

**Remainder of this Report**

- 1.8 In the remainder of this Report we:
- Assess the responses raised by stakeholders;
  - Review the impacts of changes made by Heathrow Airport in its Q6 Alternative Business Plan;
  - Based on our review of these comments set out any changes to our April 2013 commercial revenues projections.
- 1.9 In order to ensure consistency with our April 2013 Final Report all prices are given in 2011/12 real terms unless stated otherwise.

## 2 Response to stakeholder comments

### Introduction

- 2.1 This section sets out a summary of the comments made by stakeholders to the Steer Davies Gleave projections set out in our April 2013 Final Report, along with our assessment and response to those comments.
- 2.2 Our revenue per passenger projections were in between the levels proposed by Heathrow Airport (which were lower) and British Airways/Nyras (which were higher), with a relatively narrow range separating the high and low end of the forecasts, assuming use of Heathrow Airport's traffic forecast.
- 2.3 We address the comments in the following order:
- Summary of Stakeholder comments
  - Retail
  - Car Parking
  - Property
  - Other Issues

### Summary of Stakeholder comments

#### *Heathrow Airport Response*

- 2.4 Heathrow Airport disagrees with the quantum of the Steer Davies Gleave projections and argues that the CAA's proposals overstate potential commercial revenues for Q6.
- 2.5 The key concerns raised by Heathrow Airport are in summary:
- They believe that there are numerous errors and misunderstandings in our findings which have not been noted or addressed by the CAA.
  - The means of conversion of increased passenger traffic forecasts into updated commercial revenue projections by the CAA is incorrect.
  - Disagreement with the treatment of a potential ban on duty free Tobacco (which Heathrow Airport believes will take effect in 2018/19).
  - Disagreement with the quantification of the impacts on revenues of the Tobacco Display Act.
  - View that the stretch proposed for car parking is based on misinterpretation and incomplete analysis.
  - Disagreement with the means of recalculation of property revenues relating to Investment Property Databank ("IPD") indices.
  - Disagreement with assumptions about the re-letting of property voids.

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- Disagreement with the rationale supporting the proposed additional revenues attributing to the Enhanced Terminal facilities development.

2.6 Heathrow Airport has also stated that it is not possible to generate material incremental income without also increasing opex, citing additional marketing costs to support car parking revenue growth as an example of this.

### *Airlines Response*

2.7 The LACC agrees with our proposals regarding the impact of the TDA and car parking, but they have questioned whether further stretch could be applied in the retail areas. They have also asked for clarification of whether the CAA's Initial Proposals assumed a ban on duty free tobacco sales from 2018/19 as assumed by Heathrow Airport.

2.8 The evaluation by Nyras suggests that there is potentially a £120 million stretch to the CAA's Q6 forecast that might be achievable based on a combination of:

- Improving passenger confidence
- Better targeting
- Margin improvements
- Introducing pop-up stores
- Higher advertising revenues
- Taking advantage of fast changing consumer trends
- Accelerated development of e-business

### *Steer Davies Gleave Analysis*

2.9 While the rest of this section sets out our views on matters of detail, below are some comments on the headline issues raised by stakeholders and in particular the challenges raised by Heathrow Airport.

2.10 **Retail:** We disagree with the view of Heathrow Airport regarding "errors and misunderstandings" within our report. We believe we provided a balanced argument to the CAA on all of the key issues and although these were not all outlined within the CAA's Initial Proposals, they were outlined within our report and shared with Heathrow Airport.

2.11 Heathrow Airport believes that the method of calculating additional revenue from increased passenger numbers used by the CAA is incorrect. We provide our opinion on this comment later in this report.

2.12 The disagreement relating to a potential ban on tobacco sales is well documented within our Final Report and later within this document. In our view there is no evidence to suggest such a ban will take place within Q6 and our proposed solution to apply a 'tobacco factor' has not been commented on by Heathrow Airport.

2.13 Heathrow Airport disagrees with our quantification of the potential impacts of the Tobacco Display Act. This issue was also well documented in our Final Report referencing trials at Birmingham, Dublin and Gatwick along with historic Heathrow specific data outlining the difference in the size of impacts from reduction in

tobacco market size compared with restrictions on the ease of buying tobacco. Heathrow Airport has made some additional information available to us at the final stages of completing this report however in our view it still fails to provide the full picture.

- 2.14 **Car Parking:** The project to consolidate Northside car parking using PRT as the preferred transfer solution (NPP project) was viewed favourably by the airlines during Constructive Engagement. Heathrow Airport believed that the benefits to the customer and the opportunity to provide additional capacity were key in their ability to effectively yield manage the campus and maximise revenues.
- 2.15 Due to the issues around timing of the project the airlines believed additional revenue generating initiatives could be developed and that a 1-2% stretch target (£4-8 million over Q6) could be achievable.
- 2.16 British Airways' consultants Nyras accepted Steer Davies Gleave's forecasts in totality.
- 2.17 The LACC stated that they believed "there was significant scope to improve car parking at Heathrow where the utilisation of assets is barely 50% on average. We are pleased that SDG recognised this and recommended some initiatives that HAL had not previously thought of such as a restructuring short stay prices and improving the marketing message to gain growth in all pre-book categories".
- 2.18 Heathrow Airport cited a number of initiatives included in their FBP forecasts ranging from developing e-business to improving pre-book conversion rates, additional up-selling to valet and short stay, HEX cross sell and the introduction of a new hotel and parking product. In respect of reducing operating costs Heathrow Airport intended to develop a single control centre for the Airport's parking operations. Heathrow Airport claimed these initiatives were additional to their "business as usual" activities.
- 2.19 In our April 2013 Final Report we concluded that there was the ability to deliver additional stretch revenue of £8m across Q6 over and above Heathrow's FBP from:
- Improved distribution of pre-booked products via third parties (including airlines).
  - Restructuring short stay tariffs coupled with improved enforcement and signage.
  - Additional growth in long stay revenue off peak and further growth in the Valet and Short Stay pre book products.
- 2.20 Heathrow Airport however believes that the revenue identified by Steer Davies Gleave is based on misinterpretation and incomplete analysis. We refute this for various reasons including:
- Assumptions and modelling produced by Steer Davies Gleave for Q6 have been based on parking data provided by Heathrow Airport along with our experience and benchmarking with other UK airports with a high ratio of pre-booking and a similar product mix to Heathrow.
  - We have given due consideration has been given to available capacity (particularly in Short Stay car parks), margin dilution from switching to

products such as Valet and increased use of the terminal forecourts from changes to Short Stay parking prices.

- It is understood Heathrow Airport would of course review pricing as a key driver of parking revenues and would therefore allow for some changes to pricing to be included in 2013/14 Budget and consequently Q6. However we believe we have identified further opportunities as set out in our April 2013 Final Report for incremental parking income.

- 2.21 **Property:** The latest forecasts from CBRE confirm their belief that rents in outer London will improve from 2015 onwards. Whilst the recovery is currently patchy, there is more optimism looking ahead.
- 2.22 New lettings have been reported in areas around Heathrow for both offices and industrial, indicating that the market is beginning to look more positive, with increased potential to achieve a reduction in Heathrow's void property portfolio.
- 2.23 In the rest of this section we comment on matters of detail raised by stakeholders. Many of the issues raised by Nyras on behalf of British Airways were reviewed by us in April 2013. For ease of reading of this update please refer to our Final Report Addendum for our comment on issues raised by Nyras.

### Conversion of revenue per passenger projections

#### *Heathrow Airport Response*

- 2.24 Heathrow Airport believes that it is incorrect to calculate revenues by taking Steer Davies Gleave's revenue per passenger forecasts and multiplying these by the CAA's own passenger traffic forecasts. This is because the revenue projections generated by their econometric model uses various input assumptions in addition to traffic forecasts.
- 2.25 Using their own econometric model Heathrow Airport calculates that the increased passenger forecasts would generate a further £7 million in the commercial revenues projection rather than the £25 million assumed by the CAA.

#### *Airlines' Response*

- 2.26 This point has not been directly commented on by the airlines. However British Airways and the LACC have referred to recent data from other leading European airports which highlights a resurgence early in 2013 in spend per passenger trends.

#### *Steer Davies Gleave Analysis*

- 2.27 As we commented on in our Final Report Heathrow Airport uses a sophisticated and complex tool to model retail and car parking revenues.
- 2.28 However there are some important caveats to note when considering whether Heathrow Airport's comment about the conversion of revenue per passenger projections is reasonable:
- The model did not at the time of our Final Report have universal coverage (we referred to it providing projections covering 85% of Heathrow's net retail revenues).
  - The model deals with underlying growth but not impacts or capital solutions.
  - The model provides sales rather than revenue projections.

- While we commented in the Final Report that we considered the model had demonstrated acceptable forecast accuracy when compared to recent commercial trends, we also stated that the model operates within tolerances. In other words it is not 100% accurate.
- 2.29 We consider that the fact that the econometric model produces a different value to that derived by the CAA is not in itself an indicator that the revenue per passenger values suggested by the CAA are incorrect. We also note that the difference suggested by Heathrow Airport's calculation (£18 million) seems to be surprisingly large given the relatively low number of incremental passengers involved.
- 2.30 Heathrow Airport has told us that the effects in the model of the change in passenger forecasts alone are minimal. If passenger numbers only had been changed then the model would have produced incremental income similar to the £25m calculated by the CAA. However, when lower GDP forecasts were updated in the model, this produced overall marginally lower growth in retail income across Q6 equating to £18m. The combined effect of increased traffic volumes and lower GDP forecasts gave the net increase of £7m.
- 2.31 This demonstrates the importance of accurate GDP forecasts to the calculation of commercial revenues. As we discuss later in this Report the GDP assumptions used by Heathrow Airport are lower than the current projections of the IMF and OBR.
- 2.32 From a practical perspective we note that Heathrow Airport uses their econometric model under an exclusive arrangement with a 3<sup>rd</sup> party supplier. Even if the CAA accepted the technical point made by Heathrow Airport about the accuracy of its own forecast, there does not appear to be a mechanism or opportunity for the CAA to run its own forecasts (for example if it wished to test the sensitivity of the outputs to higher GDP projections) using the methodology employed by Heathrow Airport.
- 2.33 We have also considered the range of values used by Heathrow Airport in the econometric model update which supported the ABP. We discuss these later in this report, but we believe there is evidence in support of the use of alternative, higher, macroeconomic forecasts for the Q6 period. Similarly we note that the recent update does not appear to have included a wholesale revision to the model parameters and inputs. This is important as revenue per passenger is the output of a wide range of factors, not least traffic mix and passenger profile which can all be further impacted as a consequence of variables such as efficient processing through the airport and optimisation of dwell time.
- 2.34 We cannot validate this point but anticipate, from our knowledge of the model, that a full update of the model's parameters and inputs, incorporating higher GDP forecasts amongst other things, could potentially produce higher revenue per passenger forecasts than those stated by Heathrow Airport in its response to the CAA's Initial Proposals.

### Tobacco Ban

#### *Heathrow Airport Response*

- 2.35 Heathrow Airport has based its assumption of a ban in 2018/19 on advice from World Duty Free and suggests that there is a lack of alternative evidence in support of a different assumption.
- 2.36 They have also commented that the assumption acts as a catch all for other effects which they believe may otherwise be relevant (e.g. WHO initiatives on liquor, plain packaging of tobacco).

#### *Airlines' Response*

- 2.37 The airlines agree with Steer Davies Gleave's position that there is no evidence that a ban will be implemented during Q6.

#### *Steer Davies Gleave Analysis*

- 2.38 We addressed this issue in our Final Report, finding that there was no conclusive evidence to support the assumption that a ban on duty free Tobacco would be implemented within the course of Q6.
- 2.39 We believe it is likely that there will be a complete ban in the long term but also believe that such a move is very unlikely during Q6. The WHO are conducting a study to establish to what extent illicit trade in tobacco takes place within Travel Retail, and this study must be completed by 2017/18. The results of this study - if adverse - are seen by the industry as a potential tipping point leading to a ban on tobacco sales within the sector. We understand that the study has not yet started and will take some time to complete. Allowing for this, the time needed to consult on the findings, and the time to implement a ban following a legislative process, we believe a ban will not take place during Q6.
- 2.40 In addition it has now been confirmed that some of the smaller issues such as liquor minimum pricing and plain packaging of tobacco are unlikely to happen over the short to medium term. This is different to our understanding at the time of completing the Final Report, when it seemed possible that legislation relating to both of these issues would be in place by the start of Q6.

### Tobacco Display Act (TDA)

#### *Heathrow Airport Response*

- 2.41 Heathrow Airport has commented that Steer Davies Gleave's assumptions in this area are incorrect and based on a misunderstanding of benchmark data from trials at Birmingham and Dublin, and without taking into account data from Gatwick.
- 2.42 In Heathrow Airport's opinion their assumptions, which are based on World Duty Free data, are reasonable.

#### *Airlines' Response*

- 2.43 The LACC agrees with our assumptions, which they have described as "fair and reasonable".
- 2.44 Nyras previously assumed an impact of 5%, but has since revised this to 8%. The updated Nyras projections include the assumption that there will be some

mitigating effect by Heathrow Airport targeting higher margin sales in other categories.

***Steer Davies Gleave Analysis***

- 2.45 In our Final Report we assumed that there would be an impact of 12% on duty free Tobacco revenues arising as a result of the TDA, with a range of up to 20%.
- 2.46 During the course of our review we discussed the issue with World Duty Free and also received trial data from them (as stated by Heathrow Airport in its response to the CAA's proposals).
- 2.47 Due to contradictions relating to the facts about the Dublin and Birmingham trials we sought additional clarifications from World Duty Free in March 2013 about the trials it has undertaken, seeking information on:
- The % reduction or increase in space for tobacco.
  - The % reduction or increase in space for other categories.
  - The tobacco sales per departing passenger trend prior to the introduction of the TDA.
- 2.48 As mentioned earlier, some of this additional information has been made available to us at the final stage of writing this report and while in isolation this could lead the CAA to move towards the higher end of our proposed range, we do not believe the information as it now stands still provides a comprehensive picture.
- 2.49 Based on long term historical tobacco data provided to us by Heathrow Airport and World Duty Free (described in our Final Report and including periods of previous changes arising from legislation) we continue to believe that while the TDA will make it more difficult for passengers to buy tobacco it will not reduce the size of the market. Our Final Report sets out the impact on tobacco sales from 1999, highlighting when different pressures on the tobacco category came into play, and demonstrates that historical events in which it became harder to purchase tobacco (without restricting the market size) typically led to reduced sales of about 10%.
- 2.50 While we agree there should be some mitigation for lost tobacco revenue, we acknowledge that tobacco space is unlikely to reduce materially over the medium term and that the tobacco margins will be hard to replace. We have been careful not to over-emphasise mitigation within our Final Report and have not included any upside within our forecast. The recent information supplied by Heathrow Airport supports this view, demonstrating that the TDA at Birmingham resulted in 37% more space being dedicated to tobacco and 128% more space at Gatwick. We understand that tobacco space at Dublin did not increase.
- 2.51 In conclusion, having reviewed all of the data from Heathrow Airport and World Duty Free along with the challenges and comments from the airline community and their consultants, we still believe the likely negative impact on tobacco to be somewhere between 12-20%. We also believe that the CAA could consider the proposal from the airlines of applying a "tobacco factor" from 2015 as this would capture all of the potential issues, would be auditable and easy to track. It would also provide all parties with a fair outcome as it would be retrospective and based on hard facts.

### Specialist Shops

#### *Heathrow Airport Response*

2.52 Heathrow Airport did not comment specifically on Specialist Shops in its response to the CAA's Initial Proposals. However the Q6 Alternative Business Plan includes assumptions which together have led to a reduction in Specialist Shops revenues relative to the FBP of 6.8%. These include the impact of the move sequence for Terminal 2, with the detail of these moves having now been agreed with the airlines.

#### *Airlines' Response*

2.53 Nyras have not provided a forecast for individual product categories but see opportunities for development of Specialist Shops (and other Retail) arising from:

- Additional growth in underlying (i.e. excluding impactors and capital overlays) retail spends per passenger (CAGR 3.6%).
- Re-negotiation of margins (where they are in agreement with our assumption of 0.5% margin growth per annum).
- Innovation e.g. Pop Up shops.

#### *Steer Davies Gleave Analysis*

2.54 We agree with Nyras that there should be opportunities for developing specialist shops (and other retail). Having considered what the Heathrow retail estate will be post the closing of Terminal 1 and the opening of Terminal 2 we maintain the view outlined within our Final Report that the airport is under-spaced for retail by about 16,000m<sup>2</sup>, of which almost 14,000 m<sup>2</sup> would be airside.

2.55 Additionally the very challenging retail layout in Terminal 2 (as reported within our Final Report) will add further constraints to growth.

2.56 We understand that Heathrow Airport currently has a program for pop up shops and this has been particularly evident in Terminal 5. However with the space constraints already mentioned this may become more difficult to grow over the medium to long term.

2.57 In summary this is an area where we, Heathrow Airport, and the airlines have different views about the extent of the opportunity.

### Catering

#### *Heathrow Airport Response*

2.58 Heathrow Airport did not comment specifically on Catering in its response to the CAA's Initial Proposals.

2.59 As with Specialist Shops, the Q6 Alternative Business Plan includes assumptions which together have led to a reduction in Catering revenues relative to the FBP of 3.1%.

***Airlines' Response***

- 2.60 Nyras have reviewed their Catering projections and now believe that underlying revenues per passenger will grow at a CAGR of 3.4% compared to their original forecast of 1.2%.
- 2.61 The factors driving this change are:
- Margin improvements (Nyras believe there is more upside here than we had assumed in our Final Report).
  - Improvements in per passenger yields.
  - Improvement in niche brands which may be more attractive to passengers.

***Steer Davies Gleave Analysis***

- 2.62 Our views around Catering are very similar to those expressed above in relation to Specialist Shops and the lack of space available to support sustained growth.
- 2.63 Heathrow Airport has developed its catering portfolio considerably over the years, albeit this category has a slower churn rate due to the longer contract periods (to allow for payback on the high capital investment). Recent announcements regarding Terminal 2 suggest further brand/concept development.
- 2.64 In the majority of cases niche brands cannot afford the high turnover rents paid by the larger more established catering companies, in part because they lack the economies of scale, although in some situations they often work through one of the larger operators. It should also be noted that some niche brands may not always be relevant to Heathrow's International passenger base.
- 2.65 In summary we have not been presented with any new information which would lead us to change our forecast for this category.

**Advertising*****Heathrow Airport Response***

- 2.66 Heathrow Airport did not comment specifically on Advertising in its response to the CAA's Initial Proposals.
- 2.67 However the Q6 Alternative Business Plan includes an additional £5 million in advertising revenues compared to the FBP.
- 2.68 In our view Heathrow Airport has proved with the leasing of Advertising in Terminal 2 and with the improved Advertising forecast that there is room for stretch, and we therefore believe the modest targets we have proposed to be achievable.

***Airlines' Response***

- 2.69 The Nyras advertising revenues forecast for Q6 is almost identical to that of Steer Davies Gleave. However Nyras has also identified several factors which could provide upside to their forecast:
- Improving market conditions from 2014 onwards.
  - Innovation e.g. digital advertising within terminal baggage halls.

- New Content to brand and scope suitability of content for customers.

### ***Steer Davies Gleave Analysis***

- 2.70 Nyras have commented on the recent global advertising market predictions (June 2013) released by Zenith Optimedia with 1.8% growth expected this year and 3.5% in 2015. The Outdoor sector is predicted to outgrow All Media, rising from 6.8% of the total in 2012 to 6.9% by 2015. This is backed up by a similar report from Magna Global with both companies commenting on negative growth in Western Europe offset by positive growth in Asia Pacific, Eastern Europe and Latin America.
- 2.71 On the whole these reports are positive although there is limited detail behind the drivers of this growth other than unprecedented growth of 14.4% in internet advertising compared with traditional media at 1.6%. We think it is unlikely that the growth in internet advertising will be of material benefit to Heathrow Airport.
- 2.72 Nyras have made comments about possible locations for additional advertising. From our tour of the airport estate internally and externally we favour Heathrow Airport's approach of focusing quality over quantity while also exploring means to improve the approvals process which in many cases includes external stakeholders (including the airlines).
- 2.73 Nyras have also raised the fact that Chicago City Council has recently awarded Clear Channel Airports a new 5 year agreement to run the advertising and sponsorship at O'Hare and Midway paying an annual fee of US\$25 million. We are not sure of the relevance of Nyras' point here, but note that the projected revenue amounts to US\$0.58 per departing passenger compared with a global average of US\$0.68. In contrast Heathrow receives more than double that of Chicago on a per passenger basis.

## **E-business**

### ***Heathrow Airport Response***

- 2.74 Heathrow Airport did not comment specifically on E-business in its response to the CAA's Initial Proposals.

### ***Airlines' Response***

- 2.75 This is an area in which Nyras has a significantly different view to the perspective we set out in our Final Report.
- 2.76 In the opinion of Nyras E-business could be used at Heathrow to develop significant new revenue streams in addition to modernising the current means of shopping at the airport.
- 2.77 Nyras has cited a couple of examples in support of its view:
- Dublin Airport, where passengers can purchase goods on their outbound journey and collect them on return. Nyras attribute 6% of Dublin's overall turnover to this source.
  - QR Code Shopping Walls at Frankfurt and Delhi, where passengers can purchase goods on a virtual basis using QR codes on dedicated shopping walls. Frankfurt Airport describes the concept as follows:

- *“On a wall that is designed to emulate the shelves of a duty-free shop, you can put together your personal shopping basket consisting of bestsellers, new products, or special offers. All you have to do is scan a product’s QR code with your smartphone and click to submit your order to the nearest duty-free store”. The ordered items are taken to the Pick-up Counter within 15 minutes. You don’t pay until then. This virtual shopping opportunity also includes special offers that change every month. Their already-low duty-free prices are reduced by an additional 30%. All passengers can take advantage of this offering at the indicated gates, regardless of their destinations.”*

#### **Steer Davies Gleave Analysis**

- 2.78 We believe that Heathrow Airport should be encouraged to test many e-commerce related initiatives so as to establish what works well in an airport environment.
- 2.79 As outlined in our Final Report we believe that their initial investment will provide a platform to develop this channel.
- 2.80 Heathrow Airport is investing £8 million in e-commerce. This will facilitate single payment (pay once for business lounge, car park and concierge). Introduction of free WiFi could create another touch point with passengers and provide the opportunity to collect customer data and present the commercial offer, relaunch World Points as Heathrow Rewards, and provide digital mapping.
- 2.81 Nyras believe there to be much more upside but following consideration we have a different view. Heathrow Airport is developing this area on its own, almost starting with a blank canvas (ignoring car park pre booking which is already well developed). We agree that any form of pre awareness, for example advising passengers what is available at the airport (brands and promotional offers) is a good thing to do. However, the airport is a different environment to a high street or a shopping centre (in terms of residency, frequency of travel/visit, and language) and as such will take longer to develop the infrastructure and the techniques to have a meaningful impact on revenue in Q6.
- 2.82 We do however believe that Heathrow Airport is creating a platform in Q6 from which it can grow and develop meaningful revenues in Q7. A joint approach with the airlines could potentially accelerate these benefits.
- 2.83 Nyras have made reference to the Shop and Collect facility at Dublin Airport, an area where we have direct experience. The annual Shop and Collect sales are in the region of €6 million and are generated the same way as at Heathrow (i.e. passengers transact in store and collect goods on their return). Earlier this year DAA developed a transactional website for their duty free business as a trial along with some important services but this is in the early stages of development.
- 2.84 We believe that the turnover figures quoted by Nyras for Dublin include other things and do not relate solely to e-commerce.

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- 2.85 In summary we do not propose to increase our forecast through additional revenues from e-commerce.

### Car Parking

#### *Heathrow Airport Response*

- 2.86 Heathrow Airport disagrees with our car parking revenue projections, citing the following main issues:
- They disagree that there is an opportunity for sub-15 minute pricing and have requested that the quantification supporting our view be provided to them.
  - They claim that there was an imbalance in the CAA's proposals between the need for marketing to support growth in pre-book activities, while the CAA's opex proposals seek a reduction in commercial marketing costs.
  - In the absence of the Northern Perimeter Scheme ("NPP"), which is not in the latest plans, Heathrow Airport consider that the stretch proposed for pre-book activities cannot be accommodated within the existing space capacity and would cause margin dilution.

#### *Airlines' Response*

- 2.87 The airlines support our car parking revenue forecasts.

#### *Steer Davies Gleave Analysis*

- 2.88 We address the comments raised by Heathrow Airport in turn.

#### *Sub 15 minute pricing*

- 2.89 Heathrow Airport states in its response to the CAA that it reviews its pricing policy regularly and that all benefits including short stay roll-up pricing have been included in FBP. Their last review did not identify an opportunity for sub-15 minute pricing.
- 2.90 The structure of Heathrow's Short Stay tariff has not changed since 2006/7, whereas at most airports in the UK flexing time bands is common practice to maximise revenue.
- 2.91 We modelled the short stay tariffs using time band data provided by Heathrow Airport. Two models were produced and overlaid on an assumed "standard tariff increase", taking into consideration Heathrow Airport's intent to review and increase prices in 2013.
- 2.92 The structural changes we proposed (pricing every 15 minutes up to the 2 hour time band) are in operation at both Schiphol Airport and Paris Charles de Gaulle which have similar Short Stay products. At Schiphol their products "Short Stop" and "Excellence Parking" charge per 13 minutes. At Charles de Gaulle the "Drop off" product charges every 10 minutes up to 1 hour. Both airports operate an initial grace period and even allowing for this, their equivalent "up to 1 hour rate" in GBP is £7.80 for CDG and between £5.20 and £6.50 at Schiphol, rates which are higher than Heathrow where the charge is £4.90 for up to 1 hour.
- 2.93 Both airports have lower day rates in their Short Stay car parks than Heathrow, expressed in GBP. Schiphol ranges between £26 and £43 depending on the Short

Stay product and at Charles de Gaulle it is between £31 and £57. This compares to Heathrow currently at £53.90.

- 2.94 The examples above show that other major airports flex their short stay tariff structures from time to time to provide incremental revenue opportunities.
- 2.95 In our Final Report proposal we gave consideration to the daily rate reducing it to £50 as Heathrow had raised concerns about negative PR from car parking price increases. However our experience is that the media generally only comment and make comparisons about daily rates, and they tend to ignore short stay hourly rates.

#### *Marketing opex*

- 2.96 Heathrow Airport raised concerns in their response to the CAA that there is no provision in the CAA's proposals for additional marketing costs and furthermore proposals for reduced commercial opex place at risk the base revenue forecast.
- 2.97 We considered some increase in marketing support would be required to grow revenue and improve overall utilisation (particularly for the long stay products). Heathrow Airport is competitive with its pricing but market research has indicated lack of awareness among customers, as taxi and pick up/ drop off continues to grow. The use of marketing to drive parking revenues has been reinforced by Heathrow Airport's econometric analysis which indicates marketing to be a significant contributor to historic sales development.
- 2.98 We estimated the costs to support increased revenue to be circa £120K per year (2011/12 prices) and this was accounted for in our revenue calculations (i.e. net of costs). This figure was specific to driving off peak long stay pre-book performance in addition to the usual SEO and other on-line expenditure incurred by Heathrow Airport.

#### *Northern Perimeter Scheme*

- 2.99 The Business Case for the NPP was predicated on:
- Successful negotiations with the car rental operators to share bussing and reduce operating costs including Avis relocating to the western end of the perimeter road to consolidate car rental in one location.
  - The use of PRT to drive yield and revenue (as per T5 Business car park)
  - Additional space to locate Long Stay serving the CTA to be closer to the CTA thus improving market share and utilisation.
- 2.100 The consolidation of all CTA related parking on Northside would have improved the layout of the Northern Perimeter Road, improve connectivity from Northside to the CTA and the provision of additional parking capacity.
- 2.101 The success of the car rental negotiations to share common bussing was a key component of the financial business case. However at meetings we held with airport management in preparing our Final Report we understood there had been no formal discussions with the car rental operators to kick-start the project.
- 2.102 ✕.

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- 2.103 Our recent discussions with Heathrow Airport have confirmed that the only parking project planned to go ahead in Q6 is a 1,000 space deck on the T5 business car park, although it is understood additional space for CTA remains under discussion in the reduced NPP Business case.
- 2.104 PRT has also been removed from the capital plan. It was believed by Heathrow Airport that this would have delivered an equivalent PRT service to the existing Terminal 5 service for business parking using Terminals 2/3 in the CTA. The Terminal 5 business product served by PRT has resulted in increases in QSM ratings from 3.9 to 4.6 and has allowed prices to be increased (20% nominal) whilst overall utilisation has also increased from 92% to 97%. Incremental income of £8m was associated with PRT.

## Property

### *Heathrow Airport Response*

- 2.105 Heathrow Airport raised the following disagreements with our Property revenue projections:
- **IPD Indices:** They believed that the calculation has been adjusted in order to drive a higher revenue forecast.
  - **Re-letting of property voids:** They stated that it is unrealistic to assume that the current void space of about 17,000 sq. ft. can be let over the next 12 months. They do not believe that there is sufficient demand and have also commented that investment would be necessary to improve the quality of the accommodation. The capex that is required is not in the current investment plan and could not be delivered in time for the start of Q6.
- 2.106 In respect to Enhanced Terminal Facilities they made several comments:
- The opportunity to achieve a turnover related element in addition to the minimum guaranteed rent would be unlikely to be achieved within Q6.
  - They do not believe there is material upside from sponsorship opportunities.
  - Heathrow Airport considers a 10% return on Flexipot projects to represent a reasonable and balanced target.

### *Airlines' Response*

- 2.107 Nyras commented that there were many areas of the property revenue forecasts where they were in agreement with Steer Davies Gleave.
- 2.108 They listed the following areas as ones in which they had a different view or where additional clarification was needed:
- Nyras considered there may be opportunities for Heathrow Airport and the airlines to work together in order to secure a change in local planning designations which would ease the restrictions on use of airport land.
  - Differences in interpretation of the likely effects of the bmi acquisition by British Airways, which Nyras believes will enhance Heathrow Airport's income

by a further £3.3 million based on the assumption that ex-bmi services will not now move from Terminal 1 until Autumn 2015.

- Further rental income based on recent positive changes in IPD data.
- Clarification sought on how rental driver errors contained in Heathrow Airport's calculation of revenues have been treated in Steer Davies Gleave's forecast.
- Difference in view on the approach to acceptable project timescales within the space flexipot.
- Exclusion of income that could potentially be realised from letting of vacant space.

#### *Steer Davies Gleave Analysis*

- 2.109 **IPD indices:** We are surprised that Heathrow Airport has used data from July 2012 in producing its latest forecasts. The IPD data is available and can be readily updated to ensure that the most current data is used in producing the forecasts. Given that 60% of Heathrow's rentals are based on the Guide Price which uses the IPD data as one of its three criteria, using the most currently available data in setting the forecasts would seem to be appropriate.
- 2.110 Heathrow Airport have produced a further Guide Price calculation in its Q6 RBP Commercial Forecasts Presentation material which has amended passenger numbers but again retained the July 2012 forecasts as its IPD data. Since July 2012, there are now actuals for 2012/13 which demonstrate a substantial improvement on the July 2012 forecasts, and as such, to use the new data to recalculate Guide Price would show an improvement of some £0.5 million against the previous forecast.
- 2.111 **Re-letting void space:** Heathrow Airport have challenged our assumption that a proportion of the currently void space within the portfolio can be re-let. They have stated that there are no funds within their budget to bring accommodation to a reasonable standard.
- 2.112 We are aware that it is possible for tenants taking occupation of space to negotiate a rent free period or rent reduction in order to bring a facility up to standard. We also believe that funds would be made available if demand existed for the space. In our opinion this would be preferable to leaving the space void and incurring rates liabilities throughout Q6.
- 2.113 We have therefore assumed occupation of space which is currently void (and which comprises less than 20% of Heathrow's current void office stock). This may comprise offices, ramp or other currently void accommodation. We have not sought to define which space will be re-let in which year but have made an assumption that Heathrow Airport will let a proportion of currently void space in each year, and have included that provision within our calculations, to increase Heathrow property revenues by 1% over Q6.
- 2.114 **Comments on Nyras findings:** We concur with Nyras that there may be opportunities for Heathrow Airport to work with the Local Authority as stated in our Final Report, however these are as yet unquantifiable and are therefore not included within our calculations.

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- 2.115 We note Nyras's change in position on the bmi/BA merger effect on property revenues. We also note that Heathrow Airport in their "Response to Airlines' Responses to the CAA's Initial Proposals" acknowledge that British Airways have now clarified their intentions and that this would have an upside of £0.7 million across Q6.
- 2.116 We note Nyras's comments on the recent positive changes to the IPD data (which are similar to our points above). Regarding the miscalculation in Heathrow's original Guide Price Data, we were aware of this miscalculation and took it into effect in presenting our figures, as noted in our Addendum Report.
- 2.117 Nyras concurs that additional revenues should be sought from the letting of currently void space, although it has made no assumption on this within its calculations.
- 2.118 **Enhanced Terminal Facilities:** Heathrow's Airport main objection appears to relate to our assumption that a turnover related element would be achievable within Q6 for an independent lounge operator. We continue to believe that this is achievable, it has been phased in over the length of Q6, and the additional passenger numbers included in Q6 would appear to support that assumption. The numbers involved at an additional 5% are relatively small against the overall income proposed for Q6 from this element of the project.
- 2.119 Heathrow Airport has also challenged our assumption that additional sponsorship may be achievable for these facilities within Q6. They agree that this income stream will happen in due course, however they argue that it is unlikely to be achieved in Q6. Again, we see no reason to change our assumption especially given the increase in passenger forecasts.
- 2.120 Heathrow Airport's final objection has been about the return on Flexipot projects. As stated in our Final Report, the average return on projects which have been undertaken under this banner in the past 12 months is 32%. Whilst we accept that the individual nature of each of these minor projects varies, and that the potential for the return varies too, we do not believe that an average return of 10% is a sufficient projection given Heathrow's past success. We consider that the hurdle rate for these minor projects should remain at 20% average return.
- 2.121 Nyras also commented that the project timescales seemed to be over-generous. Without understanding the construction constraints for each element, it seems arbitrary to allocate a two year timescale as a measure of the project's acceptability. Nyras concurs with us over the higher hurdle rate.
- 2.122 To summarise our position:
- Based on our review we still believe the Heathrow Airport property revenue forecasts set out in the RBP could be further stretched to allow for a reduction in voids.
  - Our stretch target of 1% over the Heathrow Airport forecasts could be realised from re-letting a proportion of the currently void portfolio, which may be offices or other void areas. At current Guide Prices 16,130 sq. ft. of office lettings would achieve such a stretch.

- In addition the Guide Price forecasts seem unduly pessimistic, and do not reflect the latest IPD actuals or forecasts. We believe that the Guide Price forecasts should have been updated to include the latest projections for each of the key components supporting the calculation.
- Space remains at a premium in both Terminals 3 and 4. Heathrow Airport have told us that the current independent lounge operation in Terminal 3 is operating well and our understanding is that the passenger mix in Terminals 3 and 4 make them ideally suited to further CIP lounge operations. We continue to believe that both lounges will achieve greater than the minimum guaranteed rent over Q6 and that an allowance should be made for a turnover related payment within the property revenues.
- We also believe that if capital is at the premium that Heathrow Airport suggests as a reason for constraints on its ability to invest in its property portfolio for the letting of void space, then it will seek the highest returns possible for its space Flexipot. It would therefore suggest that our assessment that 20% is a suitable return is correct.

#### **Other Issues: 2012/13 Outturn**

##### ***Steer Davies Gleave Analysis***

- 2.123 In our April 2013 Final Report we stated that we thought Heathrow Airport's FBP projection of 2012/13 was likely to provide a plausible estimate of the outturn.
- 2.124 Heathrow Airport's Regulatory Accounts for 2012/13 show that the airport generated £437.5 million in Retail income (including Car Parking but excluding Property). This represented a small underperformance variance against the expected FBP outturn of £441 million.

**Other Issues: Macroeconomic conditions**

***Heathrow Airport Response***

2.125 Heathrow Airport has addressed changes in the macroeconomic environment by updating GDP and certain other values used in their econometric model. Their base growth projections in the Revised Business Plan are supported by the following key macroeconomic assumptions:

**TABLE 2.1 HEATHROW AIRPORT GDP FORECASTS**

Year	UK GDP	UK Cons Exp	EU GDP	ISC GDP	China GDP	Brazil GDP	RoW GDP
2012	0.3	1.2	-0.6	5.0	7.8	0.9	2.4
2013	0.7	0.9	-0.2	5.8	8.2	3.1	2.3
2014	1.6	1.4	1.0	6.5	8.0	3.7	2.9
2015	1.6	1.4	1.4	6.8	7.8	3.6	3.2
2016	2.1	1.9	1.6	7.0	7.7	3.7	3.1
2017	2.2	2.1	1.6	7.0	7.2	3.7	3.0
2018	2.1	2.1	1.6	7.0	6.9	3.8	2.9
2019	2.2	2.2	1.5	6.6	6.3	3.9	2.7

*Source: Heathrow Airport*

- 2.126 The GDP forecasts are generally lower than the previous assumptions used by Heathrow Airport for the first half of Q6. In the latter period of Q6 the key UK indicators (GDP, Consumer Expenditure) are slightly higher than previously assumed. The GDP projections for the European market remain slightly below those used in the FBP.
- 2.127 Other key inputs such as inflation and exchange rates values have not been amended and we also understand that the supporting model parameters may not have been updated either. Heathrow Airport told us that they had ‘frozen’ certain values in order to retain consistency with model runs used to support the FBP.
- 2.128 We understand that the growth rates derived from the econometric modelling have been applied to Heathrow Airport’s forecasts for 2014/15 and onwards. The projections for 2013/14 are based on Heathrow Airport’s budget.
- 2.129 Heathrow Airport have commented to us that within their Base Growth forecasts there has been an improvement to the Duty Free figures, but there is a slower projected growth trend for Books/CTN, Specialist Shops and Catering.
- 2.130 The total Q6 income (in 2011/12 prices) attributed to Base Growth is now £2.73 billion with a CAGR of 1.3%, from £2.74 billion with a CAGR of 2.4% in the FBP.

***Airlines’ Response***

2.131 In the British Airways response Nyras commented on a return to consumer confidence in Europe.

2.132 They also reported growth in commercial revenues at several leading European airports:

- Aeroports de Paris: Retail sales per passenger up 9.5% in Q1 2013.
- Fraport: Net retail revenue per passenger up 10% in Q1 2013.
- Copenhagen: Non-aeronautical revenue up 2.8% and concession revenue up 3.8%.

2.133 In addition they also cited the recent performance of several global travel retailers:

- Dufry: Sales +6.9% in Q1 2013.
- Autogrill: + 3.5% (for UK and Europe).
- Aelia: +10.7% for sales in the UK.

2.134 Nyras also commented that on a per capita basis Chinese passengers are now spending more than Japanese which is a structural boost for Heathrow as they believe China is a growing market for the airport.

***Steer Davies Gleave Analysis***

2.135 As described earlier in this report forecasts of the macroeconomic context are important as they determine Heathrow Airport's 'base growth' forecasts which represent the majority of revenues. UK and EU GDP represent two of the most important macroeconomic inputs in Heathrow Airport's model. We have compared the values they have used for these indicators (which we understand are sourced from Consensus Economics, which represents an average of the views of leading economic forecasters) to other recent forecasts from the IMF (UK and European Union GDP) and the Office for Budget Responsibility (UK GDP only).

2.136 The results are presented in Table 2.2. The key findings are:

- Over the 2013-2017 period Heathrow Airport’s UK GDP forecasts average 1.9% p.a, significantly below the OBR forecasts which average 2.4% p.a.
- Over the 2013-2018 period Heathrow Airport’s UK GDP forecasts also average 1.9% p.a., slightly below the IMF forecasts which average 2.0% p.a.
- Heathrow Airport’s forecasts for EU GDP are in line with those of the IMF.

**TABLE 2.2 COMPARISON OF GDP FORECASTS**

Year	UK GDP (Heathrow Airport)	UK GDP (IMF)	UK GDP (OBR)	EU GDP (Heathrow Airport)	EU GDP (IMF)
2012	0.3	0.2%	0.2%	-0.6	-0.5%
2013	0.7	0.7%	0.6%	-0.2	-0.3%
2014	1.6	1.5%	1.8%	1.0	1.1%
2015	1.6	1.8%	2.3%	1.4	1.4%
2016	2.1	1.9%	2.7%	1.6	1.6%
2017	2.2	2.1%	2.8%	1.6	1.6%
2018	2.1	2.5%	N/A	1.6	1.6%
2019	2.2	N/A	N/A	1.5	N/A

Sources: Heathrow Airport, IMF, OBR

- 2.137 In summary the GDP forecasts used by Heathrow Airport in general appear to be lower than some leading comparators which may have important implications should a forecast of ‘Base Growth’ alternatively use other sources of GDP forecasts as an input.
- 2.138 Heathrow Airport also provided us with assumptions on UK inflation and the exchange rate for sterling versus the dollar and Euro. Each of these was unchanged versus the assumptions used to support their FBP projections although we understand that these are important inputs to the sales forecasts.
- 2.139 Latest Consensus Economics forecasts (June 2013) present the exchange rate to be at about 1.49 (£/\$) versus the RBP/ABP assumption of 1.60, and 1.19 (£/€) versus the RBP/ABP assumption of 1.27.

### 3 Review of Q6 Alternative Business Plan

#### Q6 Alternative Business Plan

3.1 Heathrow Airport has issued a Revised Business Plan based on a £2 billion capital investment plan and has also developed an Alternative Business Plan (“ABP”) based on a £3 billion investment programme. In this section we briefly review the changes made to Heathrow Airport’s forecasts. We also consider whether these changes impact on our April 2013 projections of commercial revenues. Table 3.1 presents the ABP commercial revenue projections for the Retail, Car Parking and Property areas. Our scope of work does not include other areas of income (Rail, Other Commercial, ORC, Intercompany) included in the ABP.

**TABLE 3.1 HEATHROW AIRPORT ALTERNATIVE BUSINESS PLAN COMMERCIAL REVENUES (£M, 2011/12 PRICES)**

Period	Q6						
	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 Total	CAGR Q6
Forecast							
Passengers (m)	70.1	70.8	71.5	72.3	73.0	<b>357.7</b>	<b>1.0%</b>
Duty Free	✂	✂	✂	✂	✂	✂	✂
ASS	87.0	94.6	101.6	104.9	108.1	<b>496.2</b>	<b>5.6%</b>
Bureau de Change	✂	✂	✂	✂	✂	✂	✂
Catering	34.9	38.0	38.9	39.6	40.1	<b>191.6</b>	<b>3.6%</b>
Bookshops	✂	✂	✂	✂	✂	✂	✂
Other	6.2	6.5	6.8	7.0	7.3	<b>33.7</b>	<b>4.1%</b>
<b>Concessions Total</b>	<b>305.4</b>	<b>326.2</b>	<b>342.0</b>	<b>348.1</b>	<b>348.1</b>	<b>1,669.8</b>	<b>3.3%</b>
Car Parking (net)	✂	✂	✂	✂	✂	✂	✂
Other Services	✂	✂	✂	✂	✂	✂	✂
<b>Net Retail Income incl. Car Parking</b>	<b>418.4</b>	<b>450.9</b>	<b>471.9</b>	<b>481.9</b>	<b>485.8</b>	<b>2,308.9</b>	<b>3.8%</b>
Property	99.6	102.1	101.7	101.1	100.6	<b>505.1</b>	<b>0.2%</b>
<b>Total Commercial Revenues</b>	<b>518.0</b>	<b>553.0</b>	<b>573.6</b>	<b>583.0</b>	<b>586.4</b>	<b>2,814.0</b>	<b>3.1%</b>

Source: Heathrow Airport ABP, Totals restated by Steer Davies Gleave

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- 3.2 The ABP incorporates Heathrow Airport's revised traffic forecasts which now assume 357.7 million passengers for Q6 versus 355.2 million assumed in the FBP.
- 3.3 Table 3.2 sets out the variances in commercial revenues between the ABP and FBP. In total the ABP commercial revenues are about £13 million lower through Q6.

**TABLE 3.2 COMPARISON OF ABP AND FBP COMMERCIAL REVENUES (£M, 2011/12 PRICES)**

Period	Q6					
	2014/15	2015/16	2016/17	2017/18	2018/19	Q6 Total
Forecast						
Passengers (m)	0.6	0.5	0.5	0.5	0.4	<b>2.5</b>
Duty Free	✕	✕	✕	✕	✕	✕
ASS	-7.5	-6.4	-5.9	-7.4	-9.1	<b>-36.3</b>
Bureau de Change	✕	✕	✕	✕	✕	✕
Catering	-2.4	-0.5	-0.9	-1.0	-1.3	<b>-6.2</b>
Bookshops	✕	✕	✕	✕	✕	✕
Other	-3.0	-1.6	-0.1	1.6	-4.0	<b>-7.0</b>
<b>Concessions Total</b>	<b>-14.8</b>	<b>0.0</b>	<b>5.5</b>	<b>5.5</b>	<b>-1.9</b>	<b>-5.6</b>
Car Parking (net)	✕	✕	✕	✕	✕	✕
Other Services*	✕	✕	✕	✕	✕	✕
<b>Total Net Retail Income incl. Car Parking</b>	<b>-14.2</b>	<b>0.2</b>	<b>2.9</b>	<b>2.5</b>	<b>-5.0</b>	<b>-13.6</b>
Property	0.0	0.1	0.2	0.1	0.1	<b>0.5</b>
<b>Total Commercial Revenues</b>	<b>-14.2</b>	<b>0.3</b>	<b>3.1</b>	<b>2.6</b>	<b>-4.9</b>	<b>-13.1</b>

Sources: Heathrow Airport ABP and FBP (restated by Steer Davies Gleave)

3.4 Table 3.3 sets out the variance between the forecasts in terms of revenue per passenger.

**TABLE 3.3 COMPARISON OF ABP AND FBP COMMERCIAL REVENUES PER PASSENGER (2011/12 PRICES)**

Period	Q6				
	2014/15	2015/16	2016/17	2017/18	2018/19
Forecast					
Duty Free	✂	✂	✂	✂	✂
ASS	-0.12	-0.10	-0.09	-0.11	-0.13
Bureau de Change	✂	✂	✂	✂	✂
Catering	-0.04	-0.01	-0.02	-0.02	-0.02
Bookshops	✂	✂	✂	✂	✂
Other	-0.04	-0.02	0.00	0.02	-0.06
<b>Concessions Total</b>	<b>-0.25</b>	<b>-0.04</b>	<b>0.05</b>	<b>0.04</b>	<b>-0.05</b>
Car Parking (net)	✂	✂	✂	✂	✂
Other Services	✂	✂	✂	✂	✂
<b>Total Net Retail Income incl. Car Parking</b>	<b>-0.26</b>	<b>-0.05</b>	<b>0.00</b>	<b>-0.01</b>	<b>-0.11</b>
Property	-0.01	-0.01	-0.01	-0.01	-0.01
<b>Total Commercial Revenues</b>	<b>-0.27</b>	<b>-0.06</b>	<b>-0.01</b>	<b>-0.02</b>	<b>-0.11</b>

Sources: Heathrow Airport ABP and FBP (restated by Steer Davies Gleave)

3.5 Heathrow Airport has provided us with analysis, in nominal prices, of the key differences between the FBP and their Revised Business Plan which was published in summer 2013.

- The ABP uses the same market assumptions (e.g. passenger numbers, GDP) as the Revised Business Plan.
- The only changes in the revenue forecasts versus the Revised Business Plan are from the impacts of additional capital projects:
  - Personal Rapid Transit. This generates an additional £8 million over Q6 and is included as car parking income.
  - VIP Strategy: This provides an additional £1 million and is included as Other Services income.
  - CIP T5: No revenue has been attributed to this project.

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3.6 Excluding these impactors, the main differences between the respective forecasts are set out in Table 3.4, for Q6 overall.

**TABLE 3.4 HEATHROW AIRPORT COMMERCIAL REVENUES REVISED BUSINESS PLAN VERSUS FINAL BUSINESS PLAN (£M, NOMINAL PRICES)**

Indicator	Base Growth	Impactors	Capital Overlays	Q6 Total
FBP	3,114	-38	156	3,232
RBP	3,136	-51	126	3,209
<b>Change</b>	<b>+ 22</b>	<b>-13</b>	<b>-30</b>	<b>-23</b>

Sources: Heathrow Airport RBP and FBP, restated by Steer Davies Gleave

3.7 The key changes from the FBP are:

- **Base Growth:** Heathrow Airport econometric model re-run to incorporate adjusted annual passenger traffic forecasts and updated GDP forecasts. The model has not been updated for changes to other parameters such as inflation and the sterling exchange rate.
- **Impactors:** The Revised Business Plan includes the following changes (in nominal prices):
  - ✂. The forecast also includes a small amount of additional property income stretch (£0.6 million).
  - Material negative impacts (relative to the FBP) from a £12 million adjustment reflecting latest trading conditions for retail concessions, and an £18 million reduction relating to Terminal 2 airlines moves (where the indicative sequence assumed for the FBP has now been replaced by an agreed sequence of moves).
- **Capital Overlays:** The most important changes are:
  - **Removal of the Northern Perimeter Project.** Heathrow Airport said it was no longer possible to consolidate the car rental operators into one location. ✂.
  - **T5 CSA.** This project, which removes airside retail space in Terminal 5 in order to support development of enhanced passenger search capacity, was not included in the FB. The T5 CSA project has a £14 million adverse impact.
  - **T4 IDL Masterplan:** Previously in the FBP, this project has been rephrased. It is now assumed to generate £9 million in Q6, but this is a £1.6 million lower impact than in the FBP projection.

### Steer Davies Gleave Analysis

3.8 In this section we provide our assessment of the changes in the ABP, drawing on our analysis in the previous section along with other data.

3.9 We address the ABP Retail and Car Parking forecasts below. For Property we have no more additional comments to add.

**Retail**

- 3.10 Heathrow Airport has successfully negotiated additional revenue through better than expected contractual outcomes with Dixons, Bureau de Change and Terminal 2 in general. This supports the stretch outlined within our Final Report. It will hopefully give Heathrow Airport confidence in continuing with future contract renewals and new developments, especially in exploring new approaches to margin development such as higher margins for longer contracts as proposed in our Final Report.
- 3.11 Although the Terminal 2 contracts might not be negotiated again during Q6, we anticipate that there may be opportunities in this period in the other passenger terminals.
- 3.12 Heathrow Airport has reduced its forecast by £12 million as a consequence of adverse recent trading conditions i.e. which have been lower than previously expected.
- 3.13 We also note however Heathrow Airport's recent announcement of 4.6% retail revenue per passenger growth for the first 6 months of 2013. This is a strong performance and appears to be at odds with their proposed reduction in revenues.
- 3.14 Heathrow Airport and the airline community have agreed the final sequence and timing of airline moves for Terminal 2. This has created an £18 million shortfall in Heathrow's commercial revenues forecast. We understand from Heathrow Airport that the airlines made this decision in the full knowledge of this financial impact and have therefore accepted this as part of the holistic picture. We have not analysed the detail of this change but do understand and agree with the principle that an increase in the passengers moved from Terminal 3 into Terminal 2 will have adverse consequences for revenues, as commented on in our Final Report. However we also understand that it is expected there will be a larger and positive improvement to operational expenditures as a result of the accelerated move.
- 3.15 The Terminal 5 CSA project was mentioned at the time of writing our Final Report but had not been agreed. We understand that shops will close and the corresponding revenue has been removed from the forecast. Again, we understand from Heathrow Airport that the full financial consequences were considered by the airline community when this solution was agreed.
- 3.16 The Terminal 4 IDL project will generate additional revenue to the airport but due to a delay will cause a reduction in the Q6 forecast of around £1.6 million. It is unlikely this project can be accelerated so we have made no additional assumptions to those provided by Heathrow Airport.

**Car Parking**

- 3.17 The key financial negative impact between the FBP and Revised Business Plan results from the removal of PRT from the NPP project. This element of the NPP project delivered an incremental £8m of additional revenue.
- 3.18 In the ABP the three key elements of the original NPP Business Case (B009) have evolved:

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- Additional car parking remains in a revised scope for B009 and is understood to include additional spaces circa 1,000+ spaces close to Terminal 5 including a deck in the T5 Business car park (circa £10.6m).
  - The consolidation of car hire is removed from the Business Case.
  - PRT into the CTA is now a standalone Business Case B088 (circa £20.1m).
- 3.19 Under both the RBP and ABP scenarios it would appear from the documents provided and discussions we have held with the Heathrow Airport commercial team that some additional space serving Terminal 5 (circa 1,000+ spaces) will be provided and improvements made to both connectivity and way finding. It is understood additional space for the CTA remains under discussion with potential to use the N4 staff car park.
- 3.20 The scope for improvements to parking in the RBP although less than the original NPP (B009) project does not however change the incremental income Steer Davies Gleave projected based on short stay tariff increases or the utilisation improvement off peak in the long stay car parks. The additional revenue that we believe can be generated in relation to pre book products for short stay and valet can also still be achieved during Q6.
- 3.21 Our stretch target of 1-2% was based on pre NPP projects and both British Airways and the LACC believe improvements to car parking revenue can be delivered. We assumed that the scope and complexity of the original NPP project could result in a later delivery of the project in Q6 and as a result the Steer Davies Gleave revenue forecasts are not reliant on this project.

## 4 Conclusions

- 4.1 We have considered the comments provided by Heathrow Airport and the airlines, reviewed the changes made in Heathrow Airport's recently released RBP/ABP forecasts, and also assessed other wider recent changes in the market and macroeconomic context.
- We have reviewed in detail the comments and new data provided by Heathrow Airport on the key areas of disagreement between us but do not think these provide sufficient reason to change our assumptions in those areas.
  - Similarly we do not propose to change our assumptions in response to the comments made by the airline community and Nyras, although we acknowledge the points they have raised about the potential upturn in outlook for Q6.
  - Heathrow Airport's projections are underpinned by Base Growth projections founded on macroeconomic and other data. We have raised some concerns in this report about the input values chosen by Heathrow Airport. Given the complexity of the model used by Heathrow Airport, and the fact we do not have full access to it, we cannot validate what the effect of potential alternative assumptions (e.g. higher GDP projections) might be.
  - Heathrow Airport's ABP and RBP make a number of changes to the FBP forecasts which impact on the projections for individual product categories. However, in overall terms the quantum of the change is modest (RBP commercial revenues are 0.7% lower than the FBP projection). In our Final Report we proposed a 2.1% stretch against the FBP revenues projection for Q6.

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- 4.2 We have updated our forecasts to represent the ABP adjusted for the stretch impacts we proposed in our Final Report. This is presented in Table 4.1.

**TABLE 4.1 STEER DAVIES GLEAVE UPDATED Q6 REVENUE FORECASTS (£ PER PASSENGER, 2011/12 PRICES)**

Period	Q6					CAGR 2014/15 - 2018/19
	2014/15	2015/16	2016/17	2017/18	2018/19	
Duty & Tax Free	✕	✕	✕	✕	✕	✕
Specialist Shops	1.24	1.34	1.42	1.45	1.48	4.5%
Other Concessions	1.49	1.56	1.56	1.56	1.56	1.2%
<b>Concessions Total</b>	✕	✕	✕	✕	✕	✕
Advertising	✕	✕	✕	✕	✕	✕
Car Rental	0.19	0.19	0.19	0.19	0.19	0.0%
Other Services	0.13	0.17	0.18	0.16	0.16	6.7%
Car Parking (net)	✕	✕	✕	✕	✕	✕
<b>Services Total incl. Car Parking</b>	✕	✕	✕	✕	✕	✕
<b>Total Net Retail Income incl. Car Parking</b>	<b>6.05</b>	<b>6.50</b>	<b>6.73</b>	<b>6.78</b>	<b>6.85</b>	<b>3.1%</b>
Property	1.44	1.47	1.45	1.44	1.42	-0.3%
<b>Total Commercial Revenues</b>	<b>7.49</b>	<b>7.97</b>	<b>8.19</b>	<b>8.22</b>	<b>8.27</b>	<b>2.5%</b>

Source: Steer Davies Gleave analysis

- 4.3 Given Heathrow Airport's traffic forecasts, our revenue per passenger projections would equate to a sum of £2,873 million for Q6. In our Final Report we proposed a moderately higher total of £2,886 million.

